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USDOC FOR ITS/TD/ENERGY DIVISION
TREASURY FOR IA (ALICE FAIBISHENKO)
DOE FOR INTL AFFAIRS ALOCKWOOD, GWARD AND RDAVIS
DOI FOR MMS ORR, TEXTORIS AND KARL

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TAGS: ENRG EPET ECON PGOV MX
SUBJECT: MEXICAN CONGRESS APPROVES TEPID ENERGY REFORM PACKAGE

REF: A. Mexico 2335
¶B. Mexico 1339
¶C. Mexico 531
¶D. Mexico 209

¶1. (SBU) Summary: Following seven months of often acrimonious debate, the Mexican Congress on October 28 approved a modest energy reform package - focused almost exclusively on oil - which will give greater financial autonomy and more decision making power to the state owned oil company Pemex. The reform also introduces contract bonuses for firms that complete projects ahead of schedule or transfer technology to Pemex. However, the reform will not address the most pressing issues facing Pemex: rapidly declining production, lack of technological ability to explore in the deep waters of the Gulf of Mexico, and a Constitutional prohibition on private sector investment. Mexico has fallen from being the second largest supplier of oil to the U.S. in 2007 to fourth place as a result of declining production. The reform places strict requirements on contracts for private sector participants, rules out production sharing contracts and bans the private sector from investing in downstream activities. Domestic and international financial pressures may allow or even require the Calderon administration to introduce a second, deeper energy reform package after the summer 2009 Congressional elections - even if the opposition parties gain seats in Congress. End summary.

¶2. (U) On October 28 the Mexican Chamber of Deputies voted to approve the energy reform package by a vote of 395 to 82. This follows the Senate's October 23 approval by a vote of 113 to 6. President Calderon is expected to sign the legislation within the next few days. Most government officials and industry experts expect that the reform will be challenged in court, a move which could delay implementation of at least part of the reform package by several months.

Background:

¶3. (SBU) President Calderon first submitted the government's energy reform proposal to Congress for consideration on April 8. Experts considered the administration's proposal a pragmatic step in the right direction but described it as what was feasible and possible, not necessarily what the country needed. At that time, the Calderon administration hoped for quick passage of legislation. However, supporters of former presidential candidate Andres Manuel Lopez Obrador (AMLO) seized control of the lower house of Congress, and forced agreement among the three main political parties on 70

days of public hearings on a reform package. Over the next five months, the PRI and the FAP/PRD both developed their own energy reform proposals, leading to a lengthy congressional negotiation which resulted in a weak, lowest common denominator reform.

Elements of Package:

¶4. (SBU) Although the energy reform will help Pemex become a more transparent and flexible, firm, energy analysts agree that it will not address the key problem of maintaining production levels or identifying new reserves. The energy reform is divided into seven distinct bills which deal primarily with internal Pemex procedures and requirements. The following are the most significant elements:

--More management and financial autonomy for Pemex:
Pemex will receive complete management and budget autonomy in seven years - not ten as proposed by the Calderon administration. This is a positive development that will give Pemex greater flexibility. The challenge for the GOM will be to plan ahead and replace the revenue the government currently derives from Pemex. (Oil revenues currently account for approximately 40% of budget revenues.) Raising tax collection rates seems the most plausible if politically difficult solution to this question.

--Limited incentives introduced for service contracts:
Congress approved some limited incentives on service contracts but eliminated much of the flexibility the Calderon administration had proposed. Incentives related to performance will be clearly stipulated up front in contracts and not during the development of the project as originally proposed. Payment to the service provider

will be made in cash and cannot include a percentage of oil rent or production. Congress added penalties for service providers who do not meet the requirements of their contracts, i.e. environmental damage, delays, substandard work. However, contractors will not be penalized if exploration contracts do not lead to discovery.

--Pemex Service Contracts Exempt from Public Works Law Requirements:

The energy reform approved by congress will also allow Pemex to award contracts without following traditional government procurement rules, giving the firm greater access to technology and improving its ability to operate. For acquisitions and government purchases, Pemex can launch auctions, make restricted invitations or directly assign a contract to national and foreign companies. The company will be allowed to decide when and what to procure in order to take advantage of lower prices through bulk purchases.

--Improve Pemex administration:
The size of the Pemex Board of Directors will swell from eleven to fifteen members. Four new independent board members will be appointed by the President and ratified by the Senate. How this will affect Pemex will depend on the qualifications of the independent board members and the level of politicization of the selection process. The Pemex Board of Directors will play a substantial role in approving the secondary regulations which will outline how the new contracting scheme is implemented.

--Issue Pemex "bonos ciudadanos" or citizens bonds:
Congress approved President Calderon's proposal allowing Pemex to sell bonds directly to Mexicans. The bonds can be obtained by any Mexican citizen directly and are meant to give bond holders a closer stake in Pemex. The Congress watered down this initiative by prohibiting brokers from buying or selling these instruments.

--Allow international negotiations on transboundary reservoirs:
The reform prohibits production sharing agreements between Pemex and other parties (private companies). However, the legislation acknowledges that for transboundary fields two countries have the right to exploit hydrocarbons in a joint field. The legislation adds that how this would be defined would depend on international agreements. An international treaty on transboundary reservoirs would have to be ratified by the Mexican Senate and signed by the

President.

¶5. (SBU) Several key elements of the administration's original reform proposal were stripped from the package approved by Congress:

----Pemex will only be allowed to provide performance incentives based on whether projects are on time and whether technology was transferred.

--Private companies will not be permitted to invest in downstream activities such as transportation and storage. Nor will private firms be allowed to build and operate refineries on behalf of Pemex.

Strengthening SENER or just Creating more bureaucracy?
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¶6. (SBU) The reform package seeks to strengthen the Mexican Energy Secretariat (SENER) by giving it greater regulatory authority over Pemex and enhancing its role on energy efficiency and renewable energy technology. Three new Commissions will be created within SENER to meet these objectives. What this will mean in practice and whether this will improve transparency or efficiency is uncertain. Many experts are skeptical that these new commissions will do no more than cause confusion, delay implementation of the reforms and create red tape. One expert noted that there simply are not enough energy experts with any type of vision for the sector to direct these new entities.

--The National Hydrocarbons Commission:
The reform creates a decentralized entity, within SENER which will regulate and supervise oil exploration and exploitation. A Commissioner will be appointed by the Executive (no Senate ratification needed). This commission will regulate oil extraction and exploitation plans and will select the most adequate technology based on criteria set by the government to address energy security policies.

--National Energy Council:
The Federal Public Administration Law will authorize SENER to set the oil output platforms and establish a long-term (15 years) energy planning program. The plan will be reviewed by the Congress every year. The National Energy Council will include members of Congress, federal and state officials, academia, and the private and social sectors. SENER will issue standards on energy savings and regulate the use of alternate energy sources.

--National Commission for the Efficient Use of Energy:
The law for Sustainable Energy Management and Consumption creates a National Commission for the efficient use of energy which will be charged with fostering energy efficiency and savings. The bill also imposes sanctions on anyone who falsifies their electricity consumption levels.

Other Changes Outside the Reform Package:

¶7. The energy reform package falls short of the Calderon administration's goals in several areas. However, the GOM was able to include some significant energy related initiatives in legislation outside of the energy reform package:

--Pidiregas: Through the President's Economic Growth and Employment Program which seeks to address the current economic and financial crisis, the GOM proposed eliminating the long term infrastructure debt instruments called Pidiregas for Pemex. This initiative will increase transparency and significantly decrease Pemex' debt burden. The Pidiregas project-financing mechanism was developed to allow the government to undertake priority investment projects by contracting them out to the private sector, while deferring their registration as government expenditures in the budget. The private sector provides the financing during the construction and until the government acquires the assets. While the information on the stock

of Pidiregas liabilities is publicly available, the public debt statistics do not consolidate this information with the external debt. Pidiregas have always been controversial precisely because they have been considered off-budget items.

--Refinery: Also as part of his Economic Growth and Employment Program, President Calderon proposed using public resources - approximately $10 billion dollars - to build a new refinery. The goal is to decrease the level of gas imports (currently 40 percent of Mexican gas is imported from U.S. fineries) by strengthening Mexico's refining capacity. Although this measure was applauded by the leftist opposition party PRD, it is controversial among industry experts. Several energy experts have questioned whether the money invested in a new refinery - which generally has large start up costs and marginal returns - would not have been better spent either retooling existing refineries to raise capacity or investing in exploration and development.

--Tax Regime: Under its revised budget proposal, the Calderon administration requested and Congress approved a new tax regime for Pemex which seeks to foster oil production by differentiating tax deduction rates in proportion to production costs in various fields: for example, Chicontepec tax deductions rose from US$10 to US$ 11 per barrel while deductions for deep water production rose from US$ 15 to US$ 16.5 dollar per barrel. Although the Finance Secretariat supported this fiscal regime, it will be difficult to audit different tax regimes for existing activities in oil fields: Cantarell and Koo-Maloob Zaap, Chicontepec, deep water, and mature fields. The goal of these differentiated tax regimes is to help Pemex by reducing its tax burden, and at the same time maintaining government revenue collection.

Comment:

¶8. (SBU) As President Calderon stressed during an address to the nation on October 28, the energy reform package focuses on strengthening Pemex and making it a more transparent, modern firm. Whether Pemex will be able to take advantage of these changes to become a more efficient and profitable energy company remains to be seen. Over the next several weeks, the international oil companies and other private sector experts will carefully review the bills passed by the Mexican Congress and study the implementing regulations that SENER is drafting to determine whether this

legislation creates new business opportunities. From an initial analysis, the service companies who already work with Pemex stand to benefit more from the changes than integrated international oil companies (IOCs). However, the IOCs feel they have waited this long for the reform, they may as well carefully analyze the results for any possible opportunities.

¶9. (SBU) Politically, the energy reform debate demonstrated the ability of Mexico's political parties to work together - albeit on basis of the lowest common denominator -- to approve a reform of this controversial sector. Unfortunately, priority was placed on political agreement rather than on substantive changes. The energy reform package does not tackle the immediate problems of Mexico's rapidly declining oil production. Nor does it address the technological and financial constraints Mexico faces with respect to exploration in the ultra deep waters of the Gulf of Mexico. The GOM continues to rely on oil revenues for forty percent of its budget. As oil production falls and oil prices drop while the rest of the economy slows, Mexico will feel the financial pinch. Economic necessity may require the GOM and the Mexican Congress to debate a second, deeper energy reform package after the summer 2009 Congressional elections - even if the opposition parties gain seats in Congress.